

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. —

UNITED STATES OF AMERICA, PETITIONER

v.

CHARLES E. O'MALLEY, CLAUDE C. ALEXANDER AND
PETER G. FARROW, AS EXECUTORS OF THE WILL OF
EDWARD H. FABRICE, DECEASED

**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SEVENTH CIRCUIT**

The Solicitor General, on behalf of the United States of America, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The memorandum, findings of fact, and conclusions of law of the district court (R. 33-42)¹ are reported at 220 F. Supp. 30. The opinion of the court of appeals (Appendix, *infra*, p. 11) is reported at 340 F. 2d 930.

¹ "R." references are to the appendix to the government's brief in the court of appeals.

JURISDICTION

The judgment of the court of appeals was entered on October 27, 1964. (Appendix, *infra*, p. 18.) The government's petition for rehearing *en banc* was denied on February 8, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Under Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939 and Section 2036(a)(2) of the Internal Revenue Code of 1954, the gross estate of a decedent includes the value of any property he transferred by *inter vivos* gift, retaining "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." In the present case, the decedent retained the right to designate who would enjoy the income from certain trust property; as co-trustee, he could either pay it out currently to the income beneficiary or accumulate it for the possible benefit of contingent remaindermen. The question presented is whether the amount that is includible in his estate (a) is limited to the value of the property originally transferred to the trusts or (b) also includes the income accumulated in the trusts at the time of his death.

STATUTE INVOLVED

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 811. GROSS ESTATE.

The value of the gross estate of the decedent

shall be determined by including the value at the time of his death of all property * * *

* * *

(c) [As amended by Sec. 7(a), Act of October 25, 1949, c. 720, 63 Stat. 894] *Transfers in Contemplation of, or Taking Effect at, Death.*—

(1) *General rule.*—To the extent of any interest therein of which the decedent has at any time made a transfer * * * by trust or otherwise—

* * *

(B) under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (i) the possession or enjoyment of, or the right to the income from, the property, or (ii) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; * * *

* * *

STATEMENT

Edward H. Fabrice died a resident of Illinois on October 13, 1949. Prior to his death, he created five irrevocable trusts naming himself and two other persons as co-trustees. The trust instruments were substantially identical except for the names of the beneficiaries and the property transferred. Fabrice's daughter Janet was the beneficiary of two of the trusts; his daughter Lorraine was the beneficiary of two other trusts; and his wife was to receive the

benefit of the fifth trust. Upon termination, each trust provided for distribution of the trust property to the principal named beneficiary, if living, and to other persons in the event that the principal beneficiary was then deceased. (R. 33.)¹

Under each of the five trusts, Fabrice retained the right (in conjunction with his co-trustees) to distribute or accumulate the income of the trusts, and the income accumulated was to become part of the principal of the trusts. When Fabrice died in 1949, the total assets in the trusts had a value of \$276,741.16. The original shares of stock transferred to the trusts had a value of \$90,600, and the difference of \$186,141.16 represented accumulated income and stock purchased for the trusts with accumulated income. The Commissioner included the total amount of \$276,741.16 in the decedent's gross estate on the ground that the power retained by the decedent—to pay out or accumulate the income of the trusts—constituted a power to designate the persons who would possess or enjoy the income under Section 811(c)(1)(B)(ii) of the 1939 Code.

The district court sustained that determination only in part, holding that the property includible in the decedent's gross estate was limited to the property originally transferred to the trusts (\$90,600) and did

¹ The property in the trusts was payable to the heirs or then living descendants of the income beneficiaries if the latter failed to survive the termination of the trusts (see Exhibits A through E, part of the record on appeal but not reproduced as part of the printed record).

not include the accumulated income and the property purchased with accumulated income (\$186,141.16).³ (R. 39-40.) The court of appeals affirmed. (Appendix, *infra*, p. 18.)

REASONS FOR GRANTING THE WRIT

In its decision below, the Seventh Circuit has reaffirmed its holding in *Commissioner v. McDermott's Estate*, 222 F. 2d 665, a decision which was also relied upon by the Sixth Circuit in *Michigan Trust Company v. Kavanagh*, 284 F. 2d 502. The *McDermott* and *Michigan Trust* decisions were necessarily and explicitly rejected by the First Circuit in *Round v. Commissioner of Internal Revenue*, 332 F. 2d 590.⁴ There is thus a direct conflict between the First Circuit, on the one hand, and the Sixth and Seventh Circuits, on the other hand. The question is of substantial importance to the administration of the federal estate tax, both because provisions for the accumulation of income of a trust at the grantor's discretion are common and because the total amount of income accumulated under such provisions during the grantor's life, often exceeds the value of the property initially transferred.

1. Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, *supra*, pp. 2-3, requires the inclu-

³ The district court itself thought that the gross estate should include the accumulated income as well as the original corpus. It nevertheless considered itself bound to exclude the accumulated income from the gross estate because of a prior decision of the Seventh Circuit, *Commissioner v. McDermott's Estate*, 222 F. 2d 665.

⁴ The taxpayer did not seek Supreme Court review of the decision in *Round*.

sion in the decedent's gross estate of all property he has transferred by *inter vivos* gift, retaining for his lifetime "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." The power retained by the decedent as co-trustee in the instant case, to pay out or accumulate the income of the trusts, is clearly a power to designate the persons who shall possess or enjoy the income from the property within the meaning of Section 811(c)(1) (B)(ii) because, by accumulating the income and adding it to the principal, the settlor is able to shift the enjoyment of the income from the income beneficiary to the ultimate taker of the principal who may not be the income beneficiary.⁵ *Estate of Yawkey v. Commissioner*, 12 T.C. 1164; *Round v. Commissioner*, 332 F. 2d 590 (C.A. 1st), affirming, 40 T.C. 970; *Industrial Trust Co. v. Commissioner*, 165 F. 2d 142 (C.A. 1st). These principles have been recognized and applied by this Court in analogous situations. *Lober v. United States*, 346 U.S. 335; *Commissioner v. Estate of Holmes*, 326 U.S. 480; *Helvering v. City Bank Co.*, 296 U.S. 85; *Porter v. Commissioner*, 288 U.S. 436.

2. The court below accepted these principles in including in decedent's estate the value of the property originally transferred to the trusts (\$90,600). It held, however, that since Section 811(c) dealt only with property which has been the subject of a "transfer" by the decedent, the gross estate did not include the \$186,141 of accumulated income which was added to the trust pursuant to the powers retained by the

⁵ See footnote 2, *supra*.

trustees. It reasoned that, because the settlor had fully disposed of his right personally to enjoy the trust income, he cannot be regarded as having made further transfers when income was accumulated at his direction for the benefit of remaindermen. Appendix, *infra*, pp. 13-14.

We believe that the decision below represents far too narrow an interpretation of the statute. The decedent's failure to reserve for himself any beneficial interest in the income of the trust does not, as the court below recognized, prevent the inclusion in his estate of the property he initially contributed to the trust. By the same token, a relinquishment of any right personally to enjoy the income does not remove from the estate the income accumulated at his direction. In short, if the retention of certain controls over the disposition of the income of a trust is sufficient to justify treating the settlor as the owner of the corpus of the trust, it should certainly be sufficient to treat him as the owner of the accumulated income itself.

This result is dictated by the very theory of the estate tax provisions presently at issue. As the First Circuit noted in *Round v. Commissioner*, 332 F. 2d at pp. 595-596, the corpus of trusts such as those in this case is included in a donor's estate, because the statute treats an *inter vivos* gift of the corpus as an incomplete disposition by the donor so long as he retains the power to control the enjoyment of the income earned by the trust. See *Commissioner v. Estate of Church*, 335 U.S. 632, 644; *Estate of Sanford v. Commissioner*, 308 U.S. 39. Because the statute treats the corpus as still belonging to the donor for purposes of

the estate tax, the transferor remains chargeable with the fruits of investment of that corpus.⁶ His retention of a substantial power over the disposition of future income justifies treating him as the transferor of that income when it arises and he directs that it be accumulated in the trust. And so, the addition to corpus in the form of accumulated income which the settlor "transfers" to the trust is included in his gross estate for the same reason that the court below included the value of the property originally transferred. With regard to the addition to corpus, as with regard to the original corpus, the settlor retains for his life "the right * * * to designate the persons who shall possess * * * the income therefrom."

The Seventh Circuit's decision in *McDermott*, upon which the court relied in deciding the instant case, has been criticized by legal scholars;⁷ its correctness has been questioned by lower courts⁸ and by the concurring opinion in the instant case (Appendix, *infra*, pp. 16-17); and it has been flatly rejected by the First

⁶ A settlor who retains a discretionary power to pay out or accumulate the income of an irrevocable trust makes a transfer for gift-tax purposes whenever he directs the income to be distributed to the income beneficiary or irrevocably accumulated for the benefit of the remainderman. See Lowndes and Kramer, *Federal Estate and Gift Taxes* (1962 ed.), p. 641; Treasury Regulations on Gift Tax (1954 Code), Section 25.2511-2.

⁷ See Lowndes and Kramer, *Federal Estate and Gift Taxes* (1962 ed.), p. 434; Warren and Surrey, *Federal Estate and Gift Taxation* (1961 ed.), p. 608.

⁸ See the district court opinion in the instant case (R. 39-40), and *Michigan Trust Co. v. Kavanagh*, 171 F. Supp. 227 (W.D. Mich.), reversed on appeal, 284 F. 2d 502 (C.A. 6th).

Circuit in the *Round* case. The question involved is important and the conflict should be resolved by this Court.

CONCLUSION

For the reasons stated, it is respectfully submitted that this petition for a writ of certiorari should be granted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

LORING W. POST,
RALPH A. MUOIO,
Attorneys.

MAY 1965.

APPENDIX

In the United States Court of Appeals for the
Seventh Circuit

No. 14556 September Term, 1964 September Session,
1964

CHARLES E. O'MALLEY, CLAUDE C. ALEXANDER AND
PETER G. FARROW, AS EXECUTORS OF THE WILL OF
EDWARD H. FABRICE, DECEASED, PLAINTIFFS-
APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

*Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division*

October 27, 1964

Before DUFFY, SCHNACKENBERG and KILEY, *Circuit
Judges.*

SCHNACKENBERG, *Circuit Judge.* United States of
America, defendant, appeals from a judgment of the
district court for \$76,841.77 with interest, against it
and in favor of plaintiffs, Charles E. O'Malley, Claude
C. Alexander and Peter G. Farrow, as executors of
the will of Edward H. Fabrice, deceased.

The stipulated facts reveal that this action is for refund of federal estate tax paid to defendant by plaintiffs, and arises under the Internal Revenue Code of 1939, 26 U.S.C.A., § 1, *et seq.*

Edward H. Fabrice, a resident of Illinois, died on October 13, 1949. In December, 1936, and January, 1937, Fabrice created five *irrevocable* trusts naming himself and two other persons as co-trustees. The trust instruments were substantially identical except for the names of the beneficiaries and the property transferred. Fabrice's daughter Janet was the beneficiary of two of the trusts, his daughter Lorraine was beneficiary of two other trusts and his wife was to receive the benefit of the fifth trust.

Under each of the five trusts, the co-trustees retained the right to distribute or accumulate the income of the trusts and the income accumulated was to become part of the principal.

Fabrice retained no power to revoke, change or modify the terms of the trusts for his benefit or in any way by which he could ever acquire any interest in the corpus or income of the trusts.

When Fabrice died in 1949, the total assets in the trusts had a value of \$276,741.16. Shares of stock originally transferred to the trusts had a value of \$90,600. The difference of \$186,141.16 represented the value of accumulated income and stock purchased for the trust with such income. The Commissioner included the total amount of \$276,741.16 in Fabrice's gross estate, on the ground that Fabrice's power to distribute or accumulate the income of the trusts constituted a power to designate the persons who would possess or enjoy the income and to alter the trusts, within the meaning of §§ 811(c)(1)(B)(ii) and 811(d)(1) of the 1939 Code.

The district court determined that the aforesaid parts of the 1939 Code were applicable, but held that

the amount includible in the gross estate was only the value of the stock originally transferred by Fabrice to the trusts (\$90,600) and did not include accumulated income and property purchased with accumulated income (\$186,141.16). It relied on our decision in *Commissioner v. McDermott's Estate*, 222 F. 2d 665 (1955).¹

The parties in this case agree that the judgment entered by the district court conforms with our holding in *McDermott's Estate*. However, defendant asks us to reject *McDermott's Estate* on the authority of *Reinecke v. Northern Trust Co.*, 278 U.S. 339, 345, *Commissioner v. Estate of Church*, 335 U.S. 632, 644-6, and other cases.

After citing our holding in *Commissioner v. Gidwitz*, 196 F. 2d 813, we said, in *McDermott's Estate*, at 667-8:

"* * * The accumulations there involved, as in the instant case, were not part of the property transferred and were, therefore, not includible. The Commissioner in his attempt to escape our holding in *Gidwitz* argues that here 'the transfers were not complete until taxpayer's [decedent's] death since the property transferred is includible in his estate by reason of retained powers to designate who shall enjoy, under Code Section 811(c)(1)(B), and to change the enjoyment of the trust estate through a power to alter, amend or revoke, under Code Section 811(d)(1).' We think this attempted distinction is without merit. The transfer in the instant case was as complete as it was in the *Gidwitz* case. The trusts were irrevocable, with no power reserved in the settlor or trustee to revoke, change or modify the terms of the trusts for his benefit or in a manner by which he could ever acquire any interest

¹ It does not appear that the government applied for a writ of certiorari in *McDermott's Estate*.

in either the corpus or the income therefrom. He received the dividends (accumulations) on the trust corpus (corporate stock) solely in his capacity as a trustee. He was without power or right to receive such dividends in any other capacity. The fact that the trustee retained some control over the manner of handling the accumulations and their distribution does not militate against the fact that the transfer of the trust corpus was complete when made. Such control or power as was retained did not or could not result in any financial benefit to the trustee, and neither could it affect the rights of the beneficiaries in the aggregate. It could result in nothing more than the shifting of benefits and a determination as to the time of their enjoyment by the beneficiaries. It is thus our view that the Tax Court properly relied upon the *Gidwitz* case as authority for its position."

We discern that *Commissioner v. Estate of Church* is not inconsistent with *McDermott's Estate*. Church created an irrevocable trust but required the trustees to pay him the income for life and, under those facts, the Supreme Court held the transfer incomplete until Church's death. In the case at bar, Fabrice had no right to receive the income or corpus during his lifetime or at his death. Nor is *Reinecke* applicable, because the trusts in that case were *revocable*. *Industrial Trust Co. v. Commissioner*, 1 Cir., 165 F. 2d 142 (1947) and other cases relied on by defendant are not inconsistent with the disposition which we make of this appeal. The one exception seems to be *Estate of Round v. Commissioner*, 40 T.C. 970, where the decision does not cite *McDermott's Estate* or the Tax Court's contrary decision in *McDermott's Estate*, 12 TCM 481, 489, or its contrary dictum in *McGehee v. Commissioner*, 28 T.C. 412. These latter decisions cast some doubt upon the authority of *Round*, which was affirmed, 1 Cir., 332 F. 2d 590 (1964), in an

opinion in which the court admitted, at 595, that it was unable to agree with the Seventh Circuit.

On the other hand, *McDermott's Estate* was approved and followed in *Michigan Trust Company v. Kavanagh*, 6 Cir., 284 F. 2d 502 (1960).

Although *McDermott's Estate* was decided in 1955 and the rule stated therein has never been changed by any act of Congress, we believe that it is firmly established as the law of this circuit. Under the doctrine of *stare decisis*, even if we had any doubt as to the correctness of our holding in *McDermott's Estate*, we would not be justified, because of any of the arguments advanced by defendant, in reversing that holding at this time.

In *California State Board v. Goggin*, 9 Cir., 245 F. 2d 44 (1957), cert. den. 353 U.S. 961, 77 S. Ct. 863, 1 L. Ed. 910, the court remarked, at 45:

“* * * This Court should respect and follow our previous opinions. The trial courts are entitled to rely upon such earlier pronouncements. * * *”

In *Commissioner of Internal Revenue v. Moran*, 8 Cir., 236 F. 2d 595 (1956), at 596, the court said:

“* * * This court has repeatedly held, particularly in tax matters, that the decision of another Court of Appeals should be followed unless demonstrably erroneous or there appear cogent reasons for its rejection. *Birmingham v. Geer*, 8 Cir., 1950, 185 F. 2d 82, 85, certiorari denied 1951, 340 U.S. 951, 71 S. Ct. 571, 95 L. Ed. 686.

“It is important that, so far as possible and particularly with respect to questions affecting the administration of taxing statutes, there should be uniformity of decision among the circuits. We would not be justified in refusing to follow the decision of the Circuit Court of Appeals in the *Avalon* case [*Avalon Amuse-*

ment Corp. v. United States, 7 Cir., 165 F. 2d 653] unless convinced that it was clearly wrong. *United States v. Armature Rewinding Co.*, 8 Cir., 124 F. 2d 589, 591; *United States v. Kelley*, 8 Cir., 110 F. 2d 922, 924; *Grain Belt Supply Co. v. Commissioner of Internal Revenue*, 8 Cir., 109 F. 2d 490, 492."

See also *Lazier v. United States*, 8 Cir., 1948, 170 F. 2d 521, 526, 9 A.L.R. 2d 324.

For the reasons which we have herein stated, the judgment from which defendant has appealed is affirmed.

Judgment Affirmed.

KILEY, *Circuit Judge*, concurring.

I concur in the result achieved by the majority, because I think the stability of the law in this circuit requires that, generally speaking, no panel in this court ought to overrule the decision of another panel, and that only the court *en banc* should exercise this power.

I share the view of the district court, however, which reluctantly followed *McDermott* in its decision, since I have *grave doubt* about the correctness of the *McDermott* decision in its reliance upon *Gidwitz*. In the *Gidwitz* case the Tax Court had found as a matter of fact that the transfer was in contemplation of death and accordingly was complete in the transferor's lifetime and thus not includible in his gross estate. There was no reservation by *Gidwitz* of any dominion over the property transferred. *McDermott*, however, as settlor-trustee, reserved the right to distribute or accumulate income from the trust corpus. Yet this court held that the income was not includible in his gross estate because the transfer was as complete "as it was in the *Gidwitz* case" with no power reserved to

"revoke, change or modify" the trust for the settlor's benefit or by which he could ever acquire any interest in the income from the corpus.

This holding was rejected, after analysis, by the First Circuit in *Round v. C.I.R.*, 332 F. 2d 590 (1964), and its soundness has been questioned by legal scholars, LOWNDES AND KRAMER, FEDERAL ESTATE AND GIFT TAXES, at 434-35 (1962). The views of the First Circuit and of Lowndes and Kramer are support for the Commissioner's contention, in the case before us, that the Fabrice transfer, because he reserved dominion over the income until his death, was incomplete until the time of his death. The reservation of dominion over the income in the *McDermott* case and in the case before us is what distinguishes them from *Gidwitz*. The fact that a settlor does not or cannot benefit from the retained power is, in my opinion, immaterial to the precise question here.

A true Copy:

Teste:

*Clerk of the United States Court of
Appeals for the Seventh Circuit.*

United States Court of Appeals
for the Seventh Circuit

Chicago, Illinois, 60610

Tuesday, October 27, 1964

Before Hon. F. RYAN DUFFY, Circuit Judge; Hon.
ELMER J. SCHNACKENBERG, Circuit Judge; Hon.
ROGER J. KILEY, Circuit Judge

No. 14556

CHARLES E. O'MALLEY, CLAUDE C. ALEXANDER and
PETER G. FARROW, AS EXECUTORS OF THE WILL OF
EDWARD H. FABRICE, DECEASED, PLAINTIFFS-APPELLEES

vs.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

*Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division*

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED, in accordance with the opinion of this Court filed this day.

